State of California

170.0068

Memorandum

To: Mr. Charles Knudsen - MIC:64

Date: September 26, 1996

From: Kristine Cazadd

K. Cazadd

Subject: <u>75% Penalty Assessments, Sections 503 and 504, LTA No. 95/35.</u>

This is in response to your April 29, 1996 telephone request to Mr. Lawrence Augusta, and our subsequent phone discussion on June 25, 1996, concerning the proper interpretation of the 75% penalty assessment provision added to Revenue and Taxation Code Section 504 by SB 1726, Stats. 1994, Ch.544. Although we all are anticipating the passage of a new bill, SB 1827, to effect further changes in the structure of this penalty assessment provision, it now appears that even if that legislation is adopted, the major revision will be the removal of the 75% penalty from Section 504 and its addition to Section 503. While this amendment will partially address your concerns regarding interpretation, additional information on correct application of the penalty, will need to be disseminated to assessors in the future. The following discussion is provided in response thereto.

<u>Issues and Analysis</u>

The question, as we understand it, is how to properly advise assessors who must apply the 75% penalty to escape and/or supplemental assessments. In LTA 95/35, p.6-7, assessors were advised that the 75% penalty is applicable to <u>all</u> escape assessments made pursuant to Section 503 on or after January 1, 1995. By implication, this advice led to two conclusions which you believe may result in unintended problems for assessors.

First, because the new Sections 503 and 504 (with the 75% penalty) became effective on January 1, 1995, all escape assessments enrolled by assessors on or after January 1, 1995, <u>could</u> possibly be subject to the 75% penalty, even though the taxpayers' acts which triggered the escape assessment occurred in <u>prior years before</u> the statutory amendment was enacted. At the time the taxpayers caused the escape assessments, the penalty under the old section(s) was only 25%. If the assessor did not discover the underassessment and enroll the escape until after January 1, 1995, the penalty attached would be 75%. You question whether this raises an ex post facto argument against the enforcement of the 75% penalty for 1995 escapes for prior years.

Second, the current language in Section 504(b) seems to authorize assessors to impose the 75% penalty on escape assessments resulting from an inadvertent or non-willful taxpayer omission involving the failure to timely file the veteran's exemption (Section 531.1) and/or the homeowner's exemption (Section 531.6). For the reasons hereinafter explained, we conclude that both of these problems are resolved by appropriate statutory construction.

I. Constitutionality of 75% Penalty

Regarding the constitutionality of the 75% penalty in Section 504, the Board, as an administrative agency, has no authority to refuse the enforcement of any statute. This position is clearly stated in California Constitution, Article III, Section 3.5, as follows:

> "An administrative agency, including an administrative agency created by the constitution or an initiative statute, has no power:
>
> (a) To declare a statute unenforceable, or refuse to enforce a statute, on the basis of it being unconstitutional unless an appellate court has made a determination that such statute is unconstitutional;
>
> (b) To declare a statute unconstitutional;..."

The California Attorney General has opined that the foregoing constitutional provision applies to a county board of equalization because it fits the definition of "an administrative agency," (64 Op.Cal.Atty.Gen. 690). We have long taken the view that it also applies to the State Board of Equalization. Thus, even if Section 504 was considered unconstituional as an ex post facto law, neither the Board nor the county boards of equalization have any power to declare such provision unconstitutional or to refuse to apply it on constitutional grounds, unless an appellate court had determined that it is unconstitutional. As yet, no appellate court has made that determination.

If we were to analyze the penalty on a constitutional basis, however, there are two reasons why the statute does not constitute an ex post facto law. First, the statute in question imposes a civil rather than a criminal penalty, and ex post facto is a criminal law principle. This statute is not retroactive, nor does it impair some right that vested in the taxpayer before its enactment. There is no such thing as a vested right to violate a statutory duty or to perform an obligation (such as reporting a transfer which results in the increase of one's property tax obligation). The Legislature may, at any time, increase or decrease the penalty or remedy for failing to fulfill one's tax obligation. The use of penalties is a long-accepted, necessary part of tax law. This was thoroughly explained by the court of appeals in <u>L.B. Foster Co. v. County of Los Angeles</u>, 265 Cal.App.2d 24 (1968), where the original penalty provisions in Sections 503 and 504 were held to be constitutional, as follows:

> "The code sections referred to call for the imposition of a penalty because the property owner has committed an act in violation of a duty imposed by law. This is intended to be a civil sanction, over and above the collection of the tax which results from uniform assessment. In <u>Helvering v. Mitchell</u> (1938) 303 U.S. 391, 401 [82 L.Ed. 917, 923 58 S.Ct. 630], the court said: 'The remedial character of sanctions imposing additions to a tax has been made clear by this Court. . .. They are provided primarily as a safeguard for the protection of the revenue and to reimburse the government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud.'"

The simple but controlling question on civil penalties is whether the state has given anything for which it can ask in return. As noted above in <u>L.B. Foster Co.</u>, supra, p.28, the penalty in Section 504, (at that time set at a maximum of 10 times the assessed value of the property underassessed) was reasonable "...to reimburse the government for the heavy expense of investigation and the loss resulting from the taxpayer's fraud." This same principle would be applicable to the 75% penalty, given the rising costs of tax administration.

Regarding the imposition of a new penalty against one's **<u>prior</u>** fraudulent acts, in <u>L.B. Foster Co.</u>, supra, the taxes which gave rise to the case by that plaintiff/ taxpayer were based upon combined escape and penal assessments made for the tax years beginning 1963 and 1964, the assessments were enrolled in 1965, and the penalty statute was amended in 1966 (enacting a lower penalty). At the time of enrollment (resulting from assessor's determination that plaintiff had in fact misrepresented and underreported the costs of its inventories), Section 504 stated:

> "504. A penal assessment shall not exceed 10 times the value of the property penally assessed."

Thus, the amount of the penal assessment enrolled in October 1965, was set at 100 percent of each escaped assessment, (representing 50 percent of the total escaped-penal assessment value). By the time the court considered the case, Sections 503 and 504 had already been amended, limiting all penal assessments to 25 percent of the additional assessed value. In upholding the application of the "pre-1966 penalty" in Section 504, the court implicitly, if not explicitly, concluded that the statutes and penalty existing at the time of the assessor's discovery and enrollment of the escape assessment were appropriate for all prior years beginning with the first year the statute was in effect. If the assessor had made the escape and penal assessments after the effective date of the 1966 amendment to Section 504, the same taxpayer would have been subject only to a 25 percent penalty.

Secondly, the penalty cannot be applied to any escape or supplemental assessment resulting from an unreported change in ownership, unless it is caused by the taxpayer's fraudulent act or omission as defined in Section 503, and the property has in fact escaped assessment or been underassessed as the result.[1] The assessor must first determine that a taxpayer has **fraudulently** evaded property taxation before imposing the penalty, which is by definition limited to a narrow set of facts.[2] Until it is **discovered** that property has escaped assessment or been underassessed, the assessor is unaware of the fraudulent act or omission. Thus, the fraudulent act or omission **continues** indefinitely. Until the escape assessment resulting from the fraudulent

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[1] If the assessor discovers the error and corrects it during the regular assessment period, a penalty assessment cannot be levied. 52 Op. Cal. Atty. Gen. 150.

[2] The justification of the bill's sponsor (San Francisco County) for increasing the penalty for fraud to 75% was to punish one particular taxpayer within its jurisdiction. You may recall the situation involving a shift in the beneficial ownership of One Market Plaza in San Francisco from Equitable Life Insurance Company to the IBM Retirement Plan, in which no change in ownership statement was filed, and the assessor believed there was some indication of possible concealment.

act or omission fraud is discovered, the fraud has not ceased.

Though a fraudulent act or omission may have occurred over a number of prior years, the penalty required to be imposed is the amount called for in the statute **at the time** of discovery and **enrollment** of the escaped assessment. For this reason, Mr. Richard Ochsner frequently advised taxpayers' attorneys prior to the effective date of the legislation, that any unreported changes in ownership should be filed before January 1, 1995, if there was even a possibility of evidence indicating a fraudulent act or omission by the taxpayer, in order to avoid the imposition of the increased penalty.[3]

II. Fraudulent Act or Omission Prerequisite to Penalty

Regarding your second concern in LTA 95/35, both the current language in Section 504(b) and the proposed language in Section 503 authorizing the 75% penalty, apply exclusively to a **fraudulent** act or omission causing property to escape assessment or to be underassessed. Fraud must have **in fact** occurred in either the taxpayer's act or failure to act, constituting willful conduct related to the following: (1) failure to report (or misreport) tangible personal property on a property statement per Section 441 and on a business property statement per Section 470; (2) failure to report (or misreport) a change in ownership per Section 480; (3) failure to notify the assessor in a timely manner that property is no longer eligible for the homeowner's exemption per Section 531.6; and (4) failure to notify the assessor that property is ineligible for the veteran's exemption per Section 531.1.

The obvious implication is that the Section 503 fact situations occur only where the taxpayer knowingly reported false or incomplete information. There is no authority for the assessor to impose the penalty where the taxpayer reported false or incomplete information

[3] In adopting SB 1726, Mr. Ochsner stated that the Legislature changed the commencement date of the statute of limitations for making supplemental and escape assessments (triggered by an unreported change in ownership) to the date the change in ownership statement is filed, rather than the date the change in ownership occurred; meaning that if a change in ownership statement was not filed until after the effective date of the legislation, January 1, 1995, then the assessor's time limit for making an assessment is virtually unlimited. In some situations, the assessor may be required to make escape assessments going back 20 or 30 years (similar to the failure of a taxpayer to file an income tax return). These changes affected Sections 75.11, 531.2, and 532 as applied to taxpayers who failed to file a change in ownership statement.

inadvertently or without knowledge, i.e., without evidence of fraud. As previously discussed, the constitutionality of the current Sections 503 and 504 rests on the fact that they are administrative sanctions "'...for the protection of the revenue and to reimburse the government for the heavy expense of investigation and the loss **resulting from the taxpayer's fraud.**'" (L.B. Foster Co., supra, p.28.)

Hopefully, this addresses your concerns in regard to these penalty provisions.

KEC:ba

cc: Mr. James Speed - MIC:63
Mr. Dick Johnson - MIC:64
Mr. Bill Minor - MIC:64
Ms. Jennifer Willis - MIC:70
Mr. Lawrence Augusta

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